DOW THEORY LETTERS INC.

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THE MARKET: Ever since the 1970 lows, it has been the Transportation Average (the most speculative of the Dow Averages) which has led the market up. Those who doubt this should study the chart in Letter 539, page 3. On April 12, 1972, the Transports topped out at 275.71. It was as simple as that.

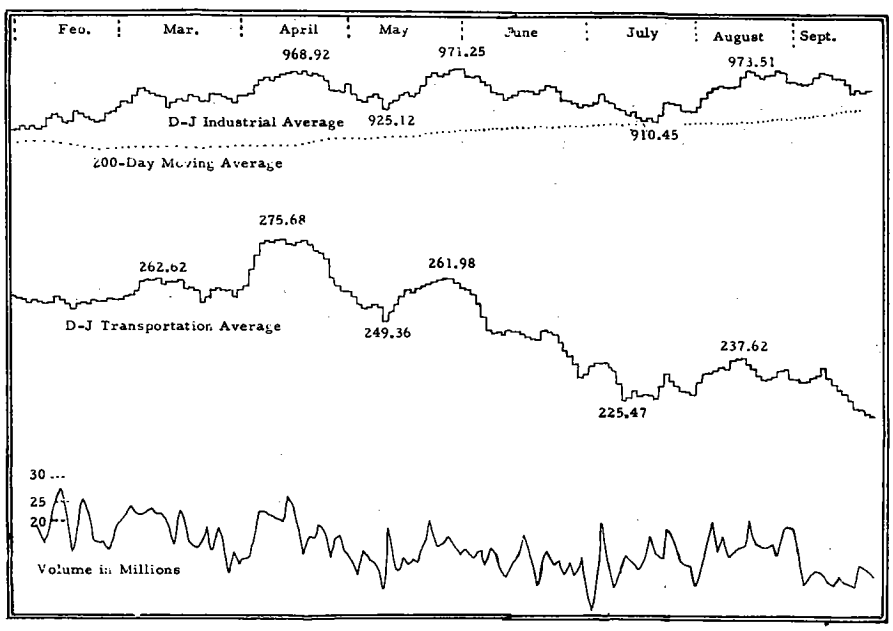
Then, just as they had been leading the way up for a year-and-a-half, Transports began leading the way down. On July 12 (see page 1 chart) Transports plunged to a low for the year at 225.47. From there a rally (confined mostly to the D-J Industrial Average) took the senior Average to a new recovery high (973.51), but Transports refused stubbornly to confirm.

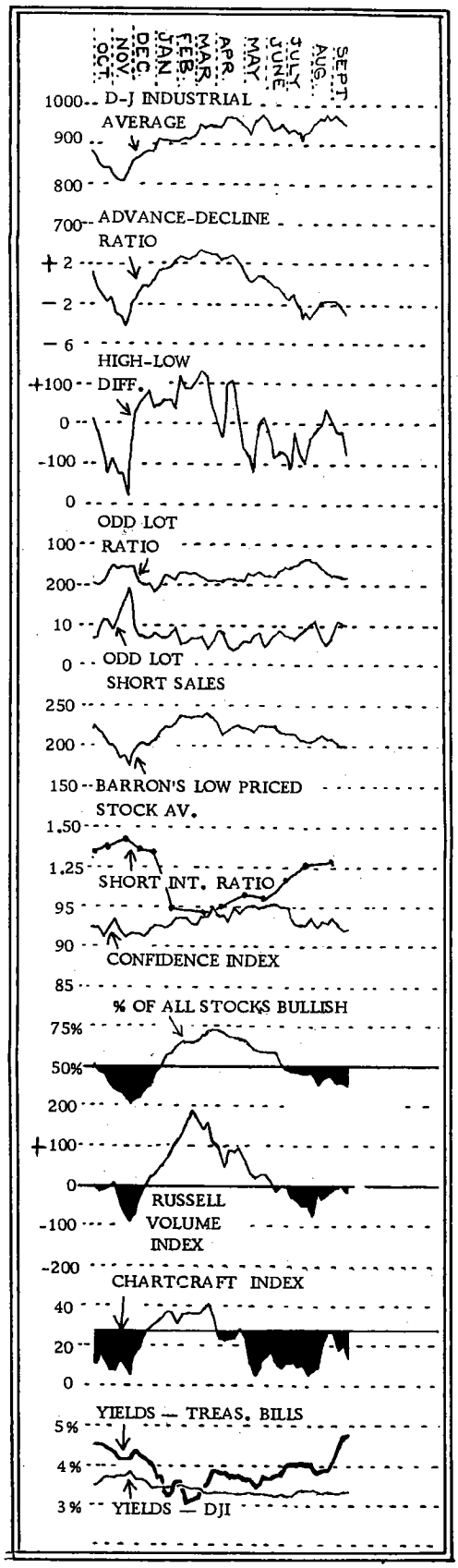
The Transportation Average pushed halfheartedly to 237.62 on August 11, then turned down again. Last week, on Monday, September 11, Transports closed at a new low for 1972. I feel the implications of this move by transports is ominous for the entire market.

Tuesday (September 12) witnessed another bearish development as the advance-decline ratio (see chart, page 2), the indicator which measures the advancing or declining tendencies of all NYSE issues, sank to a new 1972 low.

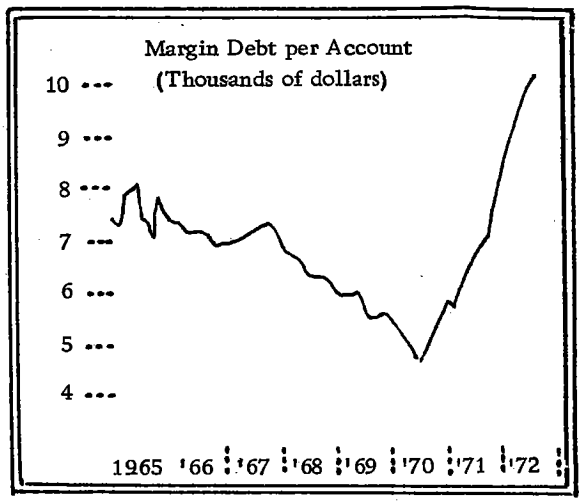
From the standpoint of Dow Theory, attention now shifts to the Industrial Average. The Transports have violated their last decline point, the mid-July low. It now remains to be seen whether Industrials will confirm by penetrating their own July 20 low of 910.45. Penetration by the senior Average of the 910.45 level would suggest a gathering of market forces for a major descent, accompanied by margin calls and widespread distress. On the other hand, continued resistance by Industrial to a penetration of the 910.45 level would indicate that the senior Average will ultimately try again for a bettering of the 1972 high.

As for my own opinion, I feel that technical weakness in the market is far too widespread and deep to allow for any respite at this time. And I "secretly" suspect that the bear, the great bear who has been in hiding since November, 1970, is about to come out of his lair and into full view again.





Incidentally, I have been calling readers' attentions to the very serious margin situation which exists in today's market (see last Letter). With margins currently at 55% and the majority of stocks eroding away, I have felt that the margin-credit position of Wall Street has become outstandingly dangerous.



I received the September 6 report put out by Dr. Martin Zweig (300 E. 46th St., N.Y.C. 10017), and the brilliant Dr. Zweig notes that "Since January the amount of debt per dollar of collateral has ballooned by 22%," which he attributes to the "...fantastic 56% increase in margin borrowings since November..."

I have drawn a chart from Martin's figures showing that margin debt per account has now risen to a level of $10,567, an all-time high! Well, what can one say, except that the greatest greed always seems to appear at the least advantageous times on Wall Street.

THE PICTURE: A friend in New York once told me about the textile salesman who was sitting in Horn and Hardart's, mumbling to himself about how terrible business was. His friend Charley, coffee and strawberry cheesecake in hand, sits down at his table. "How are things?" The salesman asks Charley, who also happens to be a textile salesman. "Oh, they're looking up!" Charley offers. "They are?" the first salesman asks incredulously. "Yeah," snaps Charley, "I'm flat on my back lookin' up."

All of which reminds me of the current political situation. I believe that Senator McGovern has hit bottom. It can only get better for him from here on (he is flat on his back looking up). And now we come to the stock market. I wrote some months ago that the possibility of a major surprise would exist if the market started heading down before the November election. If this occurred, I said, we could see a "feeding" process.

It would work this way: If the market entered a major decline, Nixon's popularity would suffer and McGovern's now dim light could shine brighter. Any rise in McGovern's election chances would panic Wall Street, and thus the feeding process becomes clear; a major market decline would help McGovern, and anything that helped McGovern would kill the market.

I also warned that if Mr. Nixon wins the election he will have to get down to serious business during his second term. I will be kind and say that Mr. Nixon's first term in office was a preparation for winning a second term. But during his second term, an American President starts thinking about his place in history, and he tends to get down to non-political, real work. If so, Mr. Nixon has to begin to deal with massive economic problems, inflation, gold, taxes, giant budget deficits, balance-of-trade deficits, runaway Government expenses, etc.

Economic Strength, But More Inflation, Foreseen for 1973

WILLIAMSBURG, Va., Sept. 6 (UPI) — Leading business economists are looking forward to continued economic strength in 1973 but also predict no letup in inflation, a survey showed today.

The study was made among members of the National Association of Business Economists, convened at their 14th annual meeting.

They predicted the nation's economy next year would better this year's already strong growth by $107-billion. They also foresaw a gross national product of $1,259-billion for 1973, a 9.3 per cent gain over the $1,152-billion expected for this year.

Is this the perfect background for a "contrary opinion" fooler in 1973?

Serious investors have all along known that Mr. Nixon was not dealing with the major economic problems. And they have also known that he would have to after the election. I suggested that investors would probably not wait until after election to distribute their wares. Men who know the enormity of the problems that Mr. Nixon has to face might well decide to sell before the election, and that seems to be exactly what has been happening. It is simply becoming more obvious now.

Then we come to another Wall Street aphorism. "When the market is not doing what it is 'supposed' to do, watch out." Now from all reports we are having a build-up for a tremendous economic boom, and throughout 1972 we have been told by everyone from Treasury Secretary Connally to the advisory ads in our local newspapers that the market is going to go through the roof.

But the facts are that the Dow hit a peak of 950.16 on March 6 and the advance-decline ratio touched its high for the year three days later on March 9. Since then, the Dow has been able to push 23 points higher (973.51 on August 19 and 22) and the advance-decline line has headed almost unabatedly lower since March. The facts do not jibe with the predictions, and the market has not done what it was "supposed to do" for the last six months! Over and over again I warned that the market was looking past the obvious — to the problems of the post-election.

Furthermore, I stated that this was a continuing primary bear market, that the 1966 high in the Dow Industrials had never been bettered, that Wall Street was living on hopes and wishes, not facts, and that the ice was getting progressively thinner. The picture was clear enough, it was simply a question of whether anyone cared to look. Of course, it is true that all through 1972 the "fundamentals" have been used to create the most flagrant kind of propaganda (they even told us that inflation was under control).

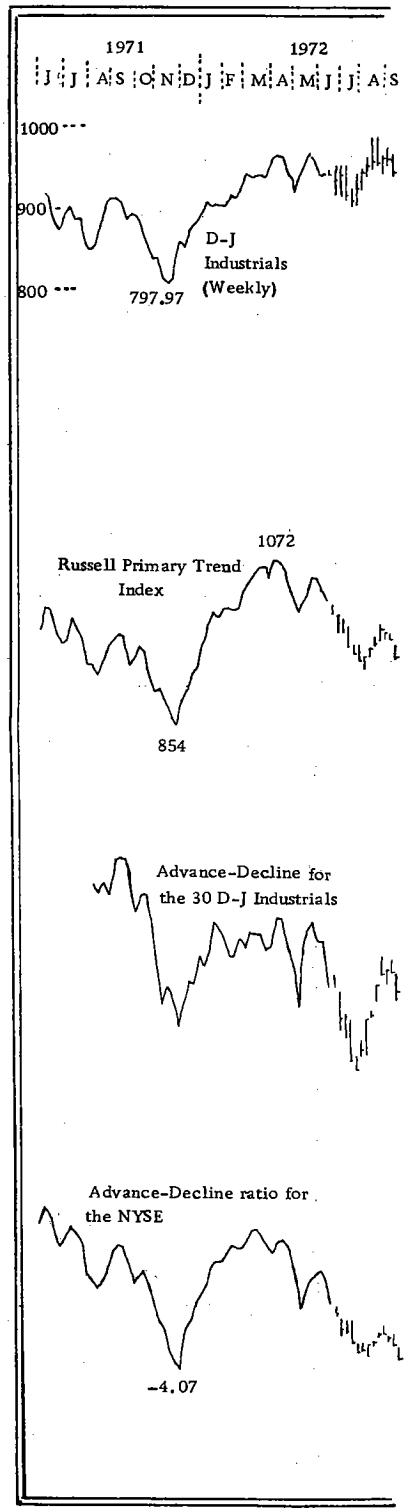
If subscribers remember, I started Letter 537 by writing about the technical analysts who had become so steamed up by what they thought they "saw" in the fundamentals that they allowed it to overrule their technical studies. No question about it, the fundamentals have never been painted in more glowing colors than they have this year. Nevertheless, the very basis of the Dow Theory and all other technical approaches to the market is that Wall Street looks ahead, it discounts, it moves before the event.

The stock market represents the sum total of what everybody knows about everything, from Wankel engines to the price of cocoa in Ghana, from the weather in Ohio to the latest blue jean styles on the Coast. That is what the whole technical approach is about — to uncode the endless mass of information contained in the market, to analyze it and put it to use.

Actually, I will admit a predilection for keeping up with the fundamentals for the following reason (I learned this, by the way, from the great Dow Theorist, Robert Rhea): When the market action is diverging from the obvious fundamentals, that is the time when the market is "talking." That is the time when the stock market barometer is fulfilling its most important function - forecasting.

Some of my friends do possess that rare ability to digest all the fundamentals and come out with intelligent and often times brilliant conclusions. One such is economist Eliot Janeway. I was therefore interested to read in his latest report, "I do find myself dissenting from the majority view that the 1972 business recovery is about to break out into a 1973 boom. I see the stock market's failure to follow through from its gains of last March being duplicated by the economy's failure to follow through from its gains to last June..." Later he notes rather ominously, "Money's next move is up in price — sharply. It has already started. An 8% level for long-term yields and a 6% level for prime short-term money is in the cards for December — not that this is by any means the tops for the yield curve."

My own talent seems to reside in the stock market area, and that is where I put the bulk of my effort. And many of the clues have been presented in these reports during 1972. There were warnings based on breadth, yields, high-lows, short interest, trendlines and dozens of other studies - and all flying in the face of a boom that was "in the bag," a boom based on the naive thesis that if the economy was going to boom, well how long could the stock market hold off?



I am including a chart (weekly high, low and close) of four indicators that I watch, all of which provide very valuable clues as to the market's underlying strength and direction. At the top of the chart is the Dow, the blue-chip Average, which is unmatched as the "standard" from which all divergent action in other indicators is gauged.

Below the Dow is the Primary Trend Index (PTI), computed each day from the action of four separate stock averages, the bond average, the A-D ratio, most-active stocks and the high-lows. This index has been diverging steadily from the Dow since April. Note that the August rally peak in the PTI occurred far below the earlier April and May peaks (although the Dow rose to a new recovery high in August). The PTI has not penetrated its important July 31 low, but it is nevertheless pointing to the lack of technical strength in the market.

The special A-D ratio for the 30 Dow Industrial stocks plunged to a new low for the year in July, snapped back sharply, and has now turned down again. It is following a path of descending peaks. Prognosis: Strength in the Dow, when it appears, is selective, weakness, when it appears, is broad.

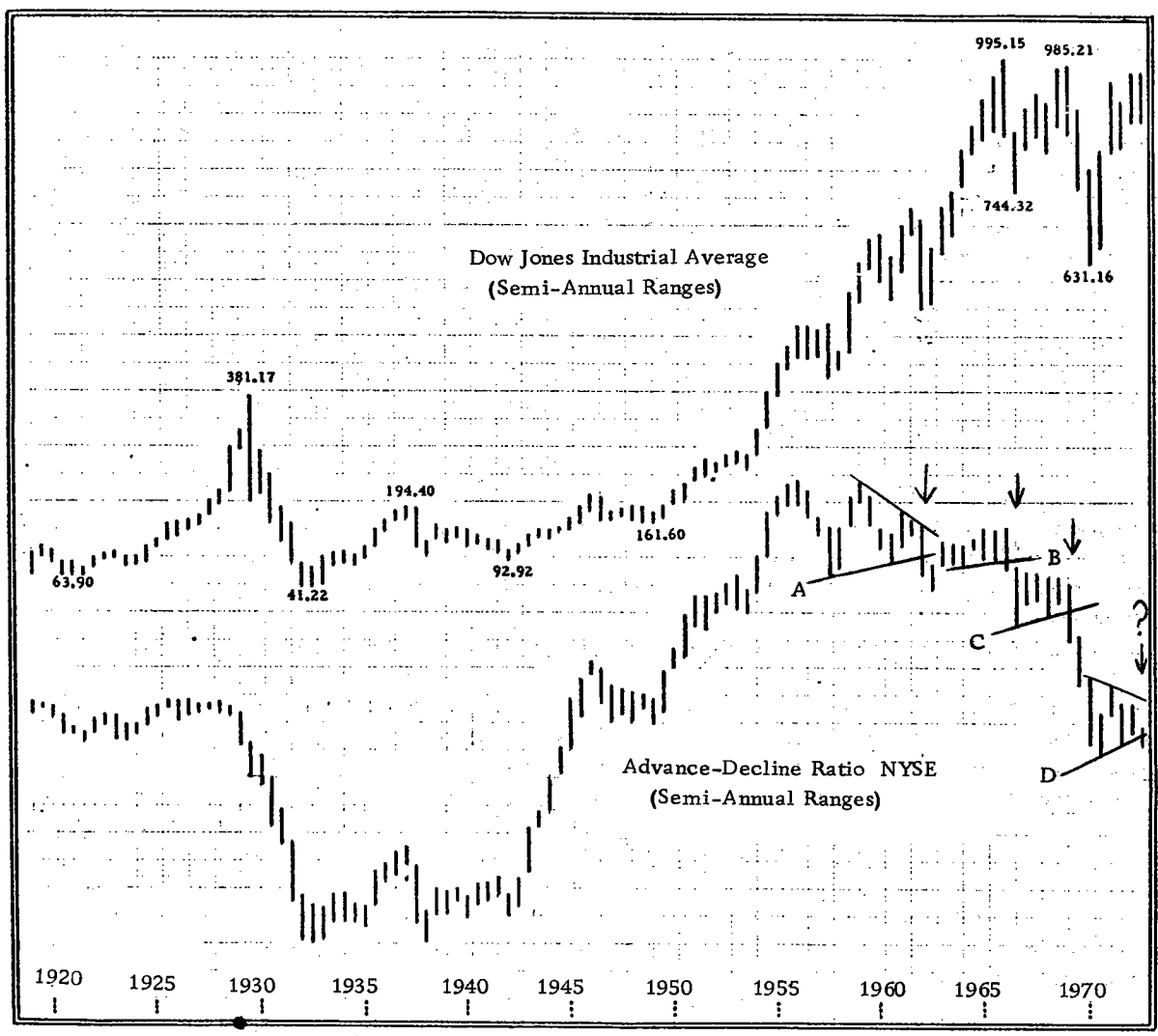
Finally, the A-D ratio for all NYSE stocks is in very poor shape as previously noted. Should it penetrate its November, 1971, low, I would say that the market is in the process of "rolling off the cliff."

LONG-TERM BREADTH: When I first started calling attention to the ominous performance of the advance-decline ratio earlier this year, I was (I believe) the only analyst to do so. In Letter 531 (June 7, 1972) I compared the current and recent breadth situation with that of 1965-66 and concluded that the "breadth-price relationship of 1971-72 is as poor as I have ever seen it." Even at that late date, few other advisors were taking note of what was happening.

Ironically, it was not until the August-September rally attempt that Wall Street began talking about the "selective market" and the "lack of breadth." The reason was obvious. No one was making any money on the rally; it was too spotty, too few stocks were moving up. The bulls had to blame their frustration on something, so they picked the lagging advance-decline ratio as the culprit. With some of the Averages at or near highs (but with most stocks showing losses) many advisors started talking about the ("deceptive") weighted averages while pointing out that the unweighted averages were behaving rather poorly (this is an observation I agreed with, see Letter 539).

With this report, I am presenting a rare and unusual chart which has appeared in Dow Theory Letters once before and never anyplace else. It is a semi-annual chart of the Dow Industrials and the A-D ratio going back to 1919! The phenomena seen on this chart would never show on a daily or weekly chart going back six months or a year or even a few years. That is why no other service is aware of what will be discussed next.

I am not going to provide a complete analysis of all the many and unusual manifestations which appear on this chart. The thing that I do want to talk about is the way breadth and price have acted since 1960. In technical analysis, we do not have



to go into "why." We are dealing basically with "how." HOW do prices act, HOW does breadth act when this or that occurs, HOW does a divergence develop, always HOW. We can show profits or avoid losses when we know "how." Knowing "why" may be fascinating, but it is neither necessary nor profitable. And our "explanations" always run the danger of being dead wrong.

Turning to the chart (page 4), I have drawn trendline "A" connecting the 1957 and 1960 advance-decline lows. This trendline was broken (down arrow) in 1962, leading to a severe market decline. A new advance-decline trendline ("B") connecting the 1962 and 1965 lows. When this trendline was broken (down-arrow), the severe 1966 bear market descent was underway.

Next, trendline "C" connected the 1966 and the first half of 1969 lows. When this trendline was broken during the second half of 1969 the market witnessed its worst collapse since 1929 with the A-D ratio suffering its worst extended decline in history.

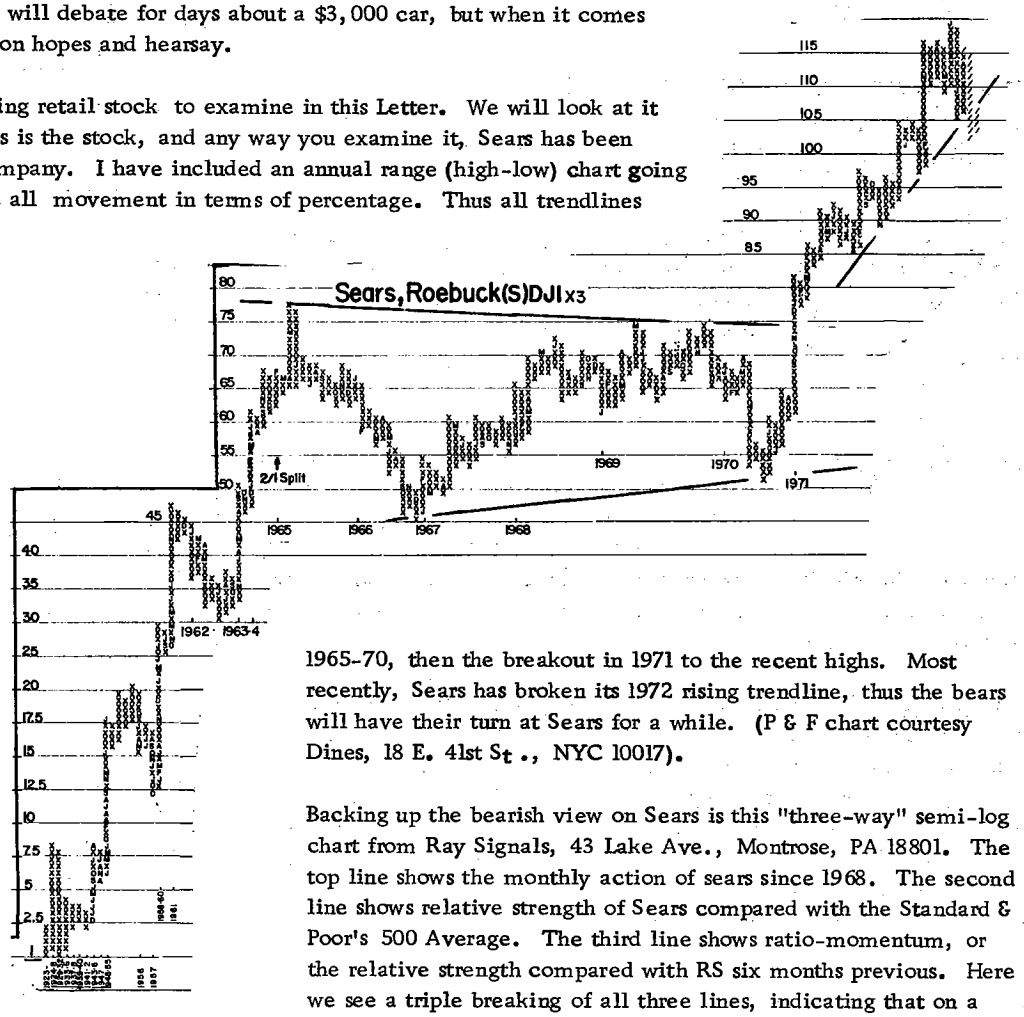
During 1970 a new pattern began to appear in the A-D ratio. The pattern formed a perfect triangle when the two six-month periods of 1971 were drawn in along with the first six-month period of 1972. The bottom of this triangle forms the trendline marked "D." As seen on the chart, the August-September (1972) decline in the A-D ratio has broken trendline D. I consider this quite bearish. But the picture would look decisive if the A-D ratio now penetrates the November, 1971, low.

If that occurs, I would say that the possibility is there for another wide-open smash on the order of 1969-70. Certainly since 1960 all compact patterns on the semi-annual A-D ratio chart, when broken on the downside, have led to severe market declines. We should shortly see whether 1972-73 will follow recent history. Remember, the decisive action would be a violation by the A-D ratio of the November, 1971, low.

STOCKS: In the last Letter I mentioned a new method of individual stock analysis I was working on. These studies are not yet ready but I do want to spend some space on stocks now.

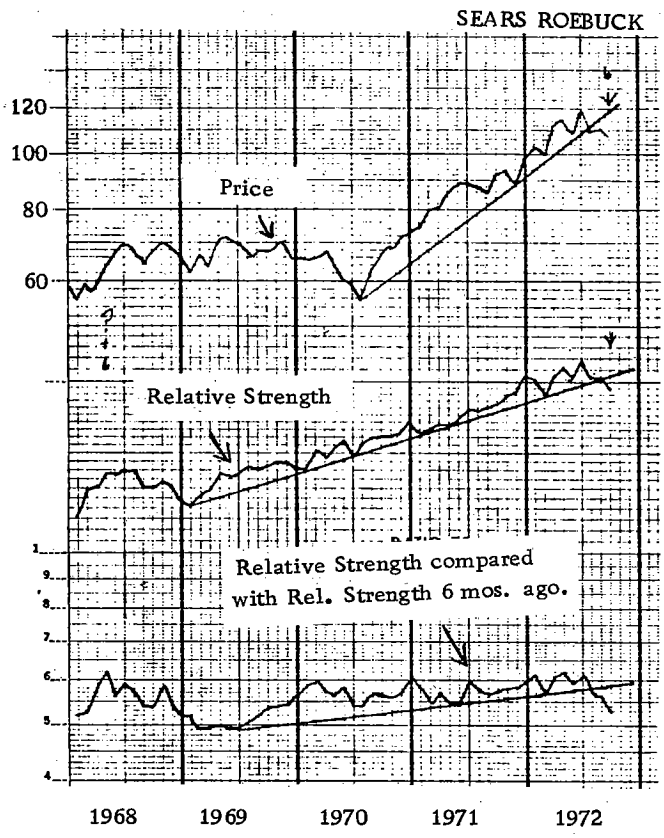
A man will spend $5,000 or $10,000 on 100 shares of stock, a holding which may fluctuate as much as 50% or more in a year. Yet he will fail (for some unknown reason) to spend an hour studying the stock, its habits, its history, its future possibility. He will debate for days about a $3,000 car, but when it comes to a stock — well, there he lives on hopes and hearsay.

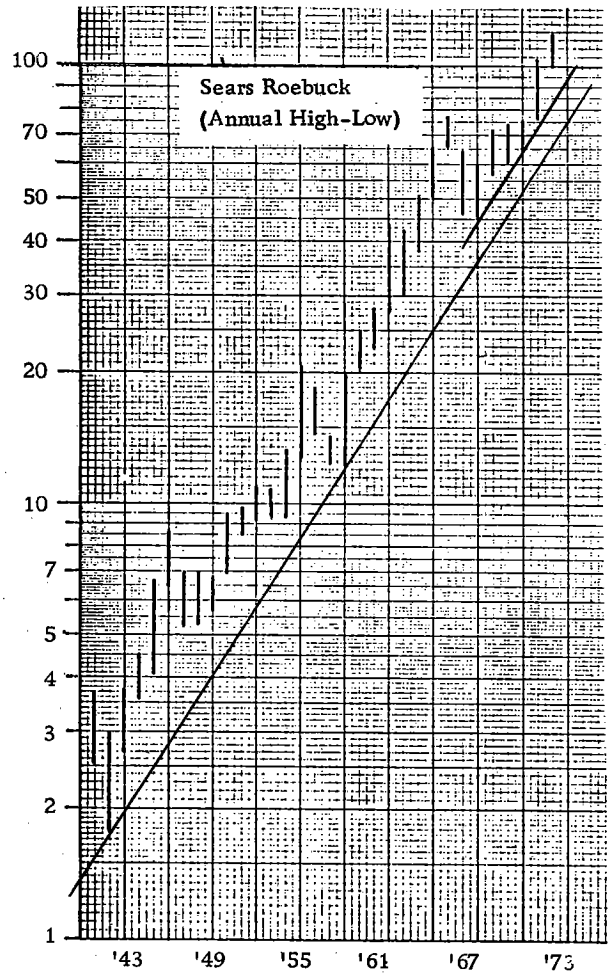
I have picked America's outstanding retail stock to examine in this Letter. We will look at it a number of different ways. Sears is the stock, and any way you examine it, Sears has been (and is) a truly great "growth" company. I have included an annual range (high-low) chart going back to 1941, and this chart shows all movement in terms of percentage. Thus all trendlines on this semi-log scale chart shows rate of rise or decline. What this graph shows is that Sears is one of those amazing companies which have maintained their growth rate over the past 30 years. The long-term ascending trendline for Sears is at 68 this year, and it will rise to 75 in 1973. A shorter-term trendline would meet any 1972 decline in Sears at 85. Thus we have guides for very long-term holders of Sears.

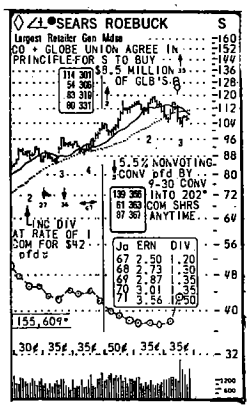


Next we have a point & figure chart of Sears, one of Jim Dine's extraordinary charts going back to 1923. Here we see all "3 points or more" movements, the dates are marked below. Point & figure shows up things no other chart will show, for instance, note the huge consolidation of 1965-70, then the breakout in 1971 to the recent highs. Most recently, Sears has broken its 1972 rising trendline, thus the bears will have their turn at Sears for a while. (P & F chart courtesy Dines, 18 E. 41st St., NYC 10017).

Backing up the bearish view on Sears is this "three-way" semi-log chart from Ray Signals, 43 Lake Ave., Montrose, PA 18801. The top line shows the monthly action of sears since 1968. The second line shows relative strength of Sears compared with the Standard & Poor's 500 Average. The third line shows ratio-momentum, or the relative strength compared with RS six months previous. Here we see a triple breaking of all three lines, indicating that on a



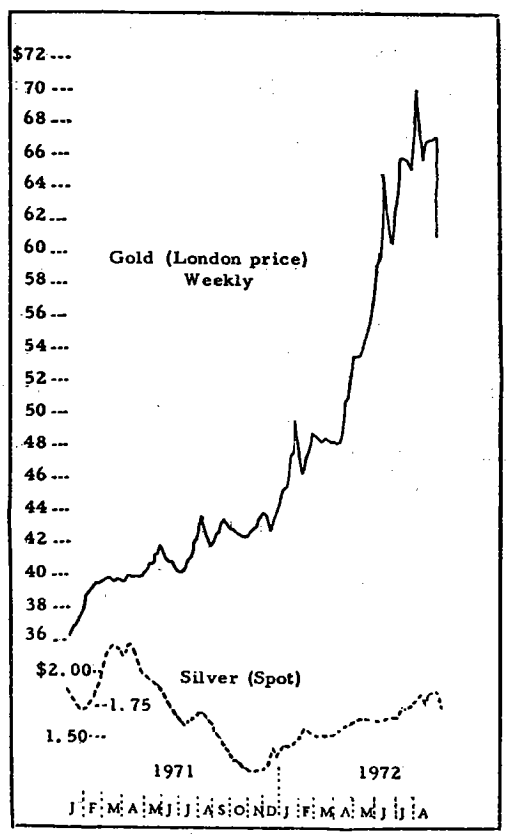




trend basis Sears has reversed its rate of ascent, it is acting poorer than the market, and its RS line is acting poorer than it did six months ago.

Yet another view of Sears is provided by this weekly semi-log chart at left, courtesy of Quote Digest, P.O.Box 213, Wichita, Kans. 67201. Here we see the 10-wk. moving average (black line) dropping below the longer 200-day moving average (dotted line), a bearish signal, which fits together with the general technical picture in Sears. At the bottom the connected circles represent the falling short position in Sears, another negative technical indication.

Conclusion: Historically, Sears has been a fabulous growth stock. For the present, however, Sears is showing technical weakness, and the stock should be avoided at this time.



SILVER & GOLD: The "umptieth" shakeout is upon us. With rumors of Russian gold sales, threats against gold by Burns and Volcker, and the IMF meeting subject to American castigations of the yellow metal, the big 1972 moves in gold and silver are being corrected. But the fundamentals are still there; no amount of hoping will wash them away. Ultimately every stock must pay out a dividend or it's a fake, ultimately every piece of monetary paper must be convertible into a "store of value" or it's worthless. That's the rule that no politician or tyrant in world history has ever negated.

Sept. 8th, Dow 961.24, PTI 960, A-D Ratio – 2.45
Sept. 15th, Dow 947.22, PTI 942, A-D Ratio – 3.22